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SUBJECT: ARGENTINA ECONOMIC AND FINANCIAL REVIEW, NOVEMBER 1 - 16, 2007

¶1. (U) Provided below is Embassy Buenos Aires' Economic and Financial Review covering the period November 1 - 16, 2007. The unclassified email version of this report includes tables and charts tracking Argentine economic developments. Contact Econoff Chris Landberg at landbergca@state.gov to be included on the email distribution list. This document is sensitive but unclassified. It should not be disseminated outside of USG channels or in any public forum without the written concurrence of the originator. It should not be posted on the internet.

HIGHLIGHTS

-- GoA raises $574 million financing at a cost two percentage points higher than in May
-- Capital flight jumps in third quarter due to international and domestic concerns
-- GoA buys back $500 million GoA debt from Social Security Administration
-- Private peso deposits decline in October, complicating BCRA efforts to reduce interest rates
-- First post-election CPI report disappoints; yet more disturbances by INDEC employees
-- GoA raises export taxes to shore up fiscal balance and reduce inflationary pressures

FINANCE

GoA raises $574 million financing at a cost two percentage points higher than in May

¶1. (SBU) On November 14, the GoA issued $574 million of a ten-year-maturity bond, the Bonar X (also known as the Bonar 2017) at a yield of 10.50%. This yield was 204 basis points higher than the strike yield from the GoA's auction of $750 million in Bonar X on May 12. (The Bonar X is a dollar denominated bond, with a 7% coupon, maturing in April 2017.) Though the GoA was able to issue more than twice the minimum amount announced ($250 million), the result was disappointing (and costly) compared to the May issue. Bids totaled $670 million, compared to the $1.9 billion received in May. Only

10% of bids were from foreign investors (low compared to other issuances over the last two years), with the majority of bids coming from local pension funds forced to repatriate funds due a recent change in local regulation (see October 26 Econ/Fin Report). Fortunately for the GoA, these shortcomings went mostly unnoticed in the media, as the auction occurred the same day that Chief of Cabinet Alberto Fernandez announced the names of President-elect Cristina Fernandez de Kirchner cabinet Ministers (she takes office December 10).

¶2. (SBU) The timing of this auction raised concern and speculation among local and foreign analysts. First, the fact that the GoA would issue bonds during the current difficult international financial environment indicates that it is in a more desperate financial situation than the market anticipated. Most analysts had expected that the GoA, to avoid issuing high-yield debt, would instead tap public entities such as the Central Bank (BCRA), the Social Security Administration (Anses) or the Argentine IRS (AFIP) to meet its financing needs for the rest of the year. (In the next month, GoA faces debt payments for about $2.2 billion.) The more optimistic view held by some analysts is that the GoA made a sound financial decision in issuing longer-term debt now as opposed to issuing short-term debt instruments to public entities. The GoA will be able to blame out-going Economy Minister Miguel Peirano for the high cost of this issue and incoming Economy Minister Martin Lousteau is positioned to look good by issuing cheaper debt after markets settle. A November 19 Ambito Financiero article reported that Minister Peirano may auction another tranche of the Bonar X before he departs the ministry on December 10.

GoA buys back $500 million debt from Social Security

Administration

¶3. (SBU) The GoA bought back approximately $500 million of debt issued under the 2005 debt exchange ("Canje") as required by the debt restructuring prospectus. According to the prospectus, the GoA has to repurchase restructured debt (e.g. Pars, Discounts or Quasi-pars) when GDP growth exceeds the base GDP growth level established in the prospectus. For 2007, private analysts estimated that the GoA would be forced to repurchase bonds of about $400-500 million. However, the GoA disappointed the market by apparently repurchasing the bonds from Anses, (the Argentine Social Security Administration), instead of purchasing bonds on the secondary market, which would have increased demand (and prices) for GoA debt. Anses has GoA bonds (mostly Quasi-pars) in its portfolio as a result of the so-called pension counter-reform, which allows workers in the private sector to transfer back to the federal government's pay-as-you go system (see February 2 Econ/Fin Report). Under the reform, private pension funds (AFJPs) transfer the funds of those who have chosen revert to the government system to Anses, and the transfers reflect the composition of the AFJPs' portfolios (which are only 5% cash and the rest in financial assets, including stocks but mainly GoA bonds). Although the GoA has not made the details of the purchase public, Embassy government contacts confirm that the GoA completed the repurchase by October 31 as required by the prospectus to avoid a technical default, and also confirm that they purchased Anses-held bonds.

Capital flight jumps in third quarter due to international and domestic concerns
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¶4. (SBU) Capital flows out of Argentina's financial system (by the non-financial private sector) reached $4.4 billion in the third quarter of 2007, according to the BCRA's quarterly foreign exchange report, released on November 1 (one week later than scheduled). This compares to inflows of $253 million in QIII 2006 and $771 million inflow in QII 2007. Some analysts speculated that the BCRA's delay in releasing

the report was to avoid announcing the negative news of capital outflows prior to the October 28 presidential elections. In its report, the BCRA blamed the increase in capital outflows on international financial turmoil, with investors seeking lower-risk assets in a "flight to quality." However, private analysts argue that domestic factors played a role. These include the deterioration of fundamentals (rapid increase in GoA expenditures, the surge in "true" inflation, and the loss of credibility of GoA statistics), along with the uncertainties surrounding the presidential election. Third quarter capital outflows from the non-financial private sector bring accumulated outflows for the year to date to $2.8 billion. Nevertheless, many analysts expect the outflows to decelerate or reverse if Cristina Kirchner announces sound economic policy measures.

¶5. (SBU) According to the report, taking into account the public sector (GoA and BCRA) and the financial and non-financial private sector, net demand for foreign currency in the third quarter reached $743 million. The private financial sector supplied $542 million of the total demand. In order to avoid an appreciation of the peso, the BCRA met the remainder through the sale of $201 million in reserves (which reduced BCRA reserves to $42.9 million at end-September). (Comment: the BCRA's net sale of foreign currency would normally contract the money supply, as the BCRA absorbed pesos in return for dollars sold. However, the BCRA more than compensated for its dollar sales by injecting peso liquidity through repo transactions and repurchasing Lebacs and Nobacs (BCRA financial instruments). Therefore, by selling dollars and simultaneously injecting peso liquidity, the BCRA attempted to avoid both a peso depreciation and an increase in domestic interest rates.)

¶6. (SBU) Other highlights of the Foreign Exchange Balance report include:
-- A surplus of $2.8 billion for the trade account of the Foreign Exchange Market for the third quarter, accumulating a surplus of $10.3 billion for the year (This is the net inflow

of FX from all trade transactions, including merchandise, services, and investment income);
-- A deficit of $3.6 billion for the capital account in QIII, generated by the $4.4 billion capital outflow from the non-financial private sector and the $1.3 billion payments (considered an "outflow") of the public sector (GoA and BCRA), partially compensated by roughly $2 billion inflows from the financial private sector. Year-to-date, the capital accounts accumulated a deficit of 182 million.

¶7. (SBU) Note: the Foreign Exchange Balance (FEB) and the Balance of Payments (BOP) report have a similar format. However, the former reports purchase and sales of foreign currency without considering the residency of the parties, while the latter reports economic transactions focusing on the residency of the intervening parties. Also, the FEB uses a cash basis methodology, while the BOP uses accrual accounting.

Private peso deposits decline in October, complicating BCRA efforts to reduce interest rates

¶8. (SBU) Political uncertainty coupled with rising inflation and concerns about the stability of the Argentine peso, which many analysts believe will depreciate further against the dollar, help explain the ARP 1.9 billion fall in private sector peso deposits (both sight and term accounts). (Peso private sector deposits reached ARP 121.6 billion at the end of October, down from ARP 123.5 in September.) Depositors shifted much of these funds into dollar deposits, which increased by $709 million (about ARP2.2 billion).

¶9. (SBU) This fall in private peso deposits does not facilitate the GoA's various initiatives to put downward pressure on interest rates (see October 26 Econ/Fin Report).

In fact, despite the BCRA efforts to inject liquidity to the system, interest rates remain stubbornly high (from 2.5 to 4 percentage points higher than in mid-July). Meanwhile, public sector deposits increased by ARP 1.4 billion during October and currently stand at ARP51.4 billion. This partially compensated for the fall in private sector deposits.

INFLATION

First post-election CPI report disappoints; yet more disturbances by INDEC employees
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¶10. (SBU) GoA statistical agency INDEC announced November 6 that the October CPI increased 0.7% m-o-m, in line with market expectations for the announcement but only about half of the level that analysts estimate for "true" or "actual" inflation. The October report actually showed a decelerating trend for prices (8.4% y-o-y compared to 8.6% in September), despite most analysts' predictions that inflation is accelerating. The INDEC report dashed hopes that the GoA would attempt to restore INDEC's credibility following the October 28 presidential elections by reporting a reading closer to independent estimates of domestic inflation. According to INDEC, accumulated inflation for the first ten months of the year reached 6.6%, compared to the 12-13% rate that most private consultants estimate. All nine sub-indexes show increases, with the largest m-o-m increases being transportation and communications (1.2%), health care (1%), education (0.7%) and leisure (0.7%).

¶11. (SBU) The local controversy over INDEC's application of "methodological innovations" to CPI numbers once again flared up following November 2 media reports that thirteen INDEC workers who had testified against Secretary of Internal Trade Guillermo Moreno had been fired. Moreno is the GoA official responsible for the government's system of price controls and is also alleged to be the mastermind behind the manipulation of INDEC data. The INDEC employees were testifying in a judicial case regarding the alleged index manipulation. INDEC subsequently issued a press release explaining that the dismissed workers' contracts expired October 31 and INDEC

management had decided not to renew them. To limit the uproar following the story, Chief of Cabinet Alberto Fernandez and Economy Minister Miguel Peirano agreed with the Civil Servant Association (Asociacion de Trabajadores del Estado) to rehire the dismissed workers for one year. The workers will now work for the Ministry of Economy, but will no longer perform their previous duties of measuring the CPI and the conducting the permanent household survey.

TRADE

GoA raises export taxes to shore up fiscal balance and reduce inflationary pressures
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¶12. (SBU) AGRICULTURE: On November 7, the GoA announced export tax increases on certain agricultural products, the ostensible goal being to increase revenues and shore up the primary fiscal surplus. The rate applied to soybeans went from 27.5% to 35%; on corn, from 20% to 25%; on wheat, from 20% to 28%; on soy oil, from 24% to 32%; and on sunflower oil, from 20% to 30%. Cabinet Chief Alberto Fernandez justified the changes in the press on November 8: "Agriculture producers should recognize that the GoA has worked to get a reasonable price for fuels used as a productive inputs, has worked to have a peso that allows them to be competitive, and that all of these entail costs that the whole Argentine society is paying for." Besides the obvious benefit of increased tax revenue, the increased taxes

also limit the impact of high world commodity prices on politically sensitive domestic food prices. Another motivation for the increase is likely the GoA's interest in taking advantage of the rally in commodity prices. For example, soy prices reached a record of $400 per ton on November 20, and have increased over 50% so far in 2007. Private sector estimates for increased revenue from the increases in agricultural export taxes vary depending on estimates of commodity prices and average exchange rates in 2008, and range from $1 to 1.8 billion per year, or approximately 0.5% to 0.9% of GDP.

¶13. (SBU) HYDROCARBONS: On November 15, the GoA announced additional tax increases, this time for export taxes on hydrocarbon exports. The new measure, which entered into effect November 19, fixes the export tax on all hydrocarbon exports at 45%, as long as the world price for crude oil is above $45/barrel. It also caps the maximum market price of Argentine crude oil at $42/barrel for domestic sales. Well-known local economists, such as Miguel Angel Broda and those at the prominent consulting firm FIEL, estimate the measure will result in increased revenues of between $850 million and $1 billion. However, other local analysts comment that the real reason for the increase in hydrocarbon export taxes was not so much revenue as domestic price stabilization. In fact, the measures may end up effectively redirecting the bulk of Argentine hydrocarbon production (both crude and refined) to domestic consumption, and so may not be a significant source of new revenue. A second and more Machiavellian interpretation is that the GoA increased hydrocarbon tariffs to reduce the value of energy sector assets, such as those of Repsol/YPF (negotiating the sale of 25% of YPF assets to domestic investors) and Exxon (which has put all of its Argentine refining and retail operations on the block).

¶14. (SBU) FIEL estimates that revenue from export taxes (for all goods, including hydrocarbon products) will be 2.32% of GDP in 2007 and increase to 2.92% of GDP in 2008, which will contribute significantly to President Cristina Fernandez de Kirchner's goal of increasing the primary fiscal surplus to 4% in 2008.
WAYNE